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ABSTRACT

Ways that college trustees can manage endowments are considered. It is suggested that endowment may be a key to survival for institutions facing serious financial difficulties. A frequently overlooked source of potential income is cash balances, which should be a concern of trustees, and one that should not be passed to professional managers. It is possible to develop a consistent set of objectives including growth of the endowment to maintain purchasing power, spending for curriculum use, an investment strategy to aim at the required investment return. It is important that trustees be aware of the performance record of their endowment funds, that they compare this record with the performance of the funds and of market indexes, and that they do not allow themselves to be misled by deceptive comparisons. Individual trustees must take the responsibility for identifying and eliminating conflicts of interest. The difficult task of selecting and evaluating professional managers for endowment funds is another trustee responsibility. The use of pooled funds is an alternative when institutions do not have large enough endowments to demand separate management. (SW)

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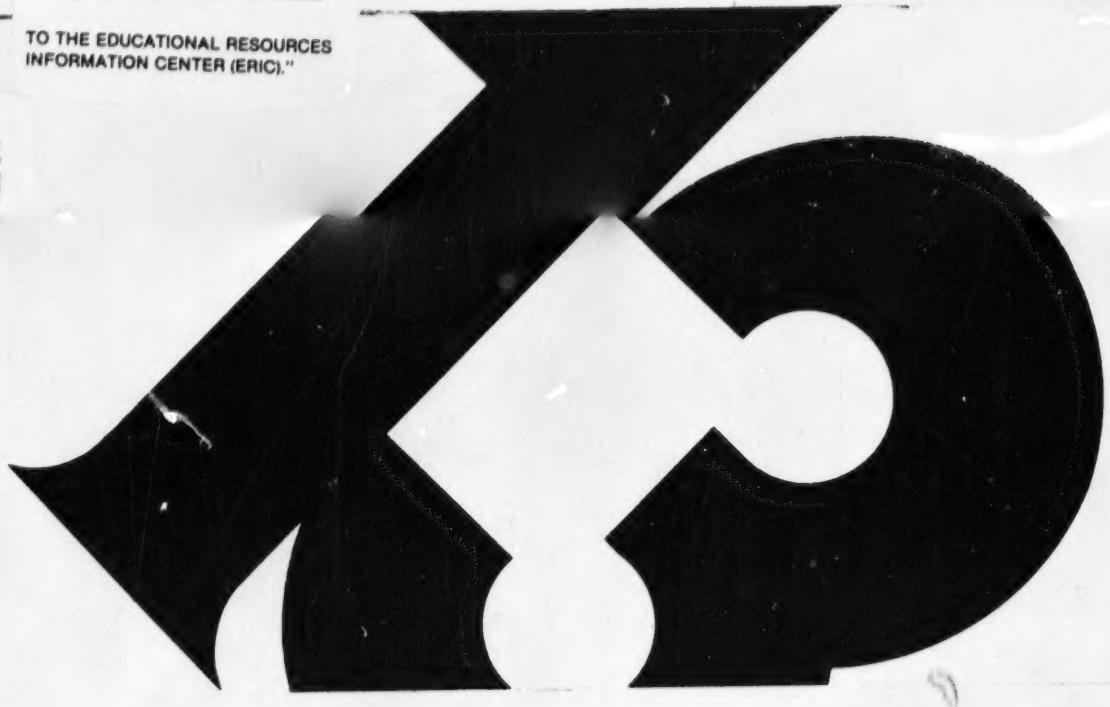

Association of Governing Boards of Universities & Colleges

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Managing Your Endowment

To the vast majority of colleges and universities, both public and private, endowment probably still looks like a luxury. The 30 or so institutions with endowments of $100 million or more may well be envied as a privileged elite, relatively free of the financial anguish that besets so much of higher education. Even the 200 institutions with $10 million to $100 million of endowments make up a very special class.

But approximately 600 institutions have endowments of one to $10 million, not enough to support much luxury but able to make a difference and something to build on, while another 900, with endowments of less than $1 million, have at least made a start.

For some institutions endowment may well be the key to survival. The prospect of shrinking aggregate enrollments in the 1980s with institutional cost rising faster than students' ability to pay, suggests that reliance on tuition as the sole or principal source of revenue is dangerous. Even public institutions, envied for the past couple of decades by the private schools for their access to taxpayer bounty, are running into serious resistance at the legislative level and are discovering how difficult it is to rely on appropriations based on head count.

Some governing boards seem ready to give up in despair. Perhaps they should, if their institutions are really not worth preserving. Others, fortunately, are determined to do their best. The 1,500 institutions with endowments of less than $10 million are not rich but they have a chance. Theirs is not an exclusive club. It can be joined by hard work and a little imagination. It is primarily to this group of 1,500, and to those who intend to join them, that this paper is directed.

The institution's investment resources

For purposes of this discussion, the strict legal definition of "endowments" is a little narrow. It embraces only the funds that are permanently invested to generate income for the support for the institution. But investible funds—funds that can contribute to this flow of income—go well beyond the narrow definition.

One of the frequently overlooked sources of potential income is cash balance. Almost every institution has intermittent surplus cash, from tuition payments, from receipt of grants, from a gift. Some even have substantial cash balances most of the time. Cash balances are a source of comfort to administrators and trustees, who are relieved of worrying about sudden shortfalls in revenue or increases in expenses. They can also be a source of substantial income, and probably there is far more potential for increasing revenue through better management of cash balances than through better management of endowment. Cash balances are much more widely distributed among institutions than is endowment. And while almost all endowed institutions are sensitive to the earning power of endowment, a great many are unaware of the earning power of cash balances.

How many trustees know what the average cash balance is for their institution? How many know whether that balance rests in a checking account, gathering no interest? If the balance is invested in treasury bills or commercial paper or some other appropriate short-term instrument, how many trustees

know how profitable that investment is? How many know the alternative investments available, and by how much the income might be increased?

Trustees who want to improve the financial position of their institution may find they can accomplish more by obtaining answers to these questions than they can by attempting to improve the management of what is strictly endowment. The use of appropriate pooled funds (like the Common Fund for Short-Term Investments*) combines a fairly high rate of income with the ability to draw on funds on less than 24 hours notice should cash be needed for operating purposes.

Cash balances are a rather special resource. Turning to the more traditional income-producing financial assets we find they generally form part of the institution's endowment. They may constitute what is generally called "true endowment", meaning investment funds given to the institution on condition that only the income is spent, or they may include so-called "quasi-endowment" or funds functioning as endowment. The latter are investment funds the trustees have chosen to set aside to generate income for the institution's support.

Not all trustees are aware of just what constitutes their institution's endowment. Financial reports vary a good deal in their usefulness at answering these questions: How large is the total endowment, at market value? How much of this is "true endowment", and how much is "quasi-endowment"? How much of the endowment is represented by investments over which the trustees have control, and how much consists of property they are forbidden to dispose of, or property managed by someone who is not responsible to the trustees, or perhaps property that is a part of the institution itself? Some institutions have invested substantial portions of their endowment funds in revenue-producing campus property like faculty housing or dormitories or dining halls.

It is remarkable how many institutions furnish their trustees with financial reports that give no clear answers to these critical questions. No trustee can act responsibly in the overall supervision of the institution's investments without a clear understanding of what those investments are and to what extent they can be controlled by the board.

Setting investment objectives

The most important statement about setting objectives is that this function is the responsibility of the board of trustees, or of a committee of the board. Many trustees find this an unwelcome task, and would prefer to turn it over to hired professional managers. A manager who asks for a statement of objectives and is told "we want no part of that, it is your responsibility" operates under a serious handicap in trying to serve the institution. Professional managers are hired primarily to make specific investment decisions, e.g., to buy and sell stocks and bonds, or to buy and sell parcels of real estate. They can only meet the needs of the institution if they are given a statement of objectives and policy from the trustees. A good manager can offer substantial help in formulating a statement of objectives, but the statement must be that of the board. It represents the policy of the institution, not the professional market judgment of the manager.

A start on setting objectives can be made by considering the following equation:

Rate of Return on Investments (income plus appreciation), plus rate of gift additions, minus erosion of investments due to inflation, minus spending rate, equals growth rate of endowment.

The first term in the equation represents the investment performance of the endowment. This will come in the form of income plus appreciation in the value of the investments. The second term accounts for the fact that most institutions with endowment funds attract gifts which serve to in-

*For information on The Common Fund, write The Common Fund, 635 Madison Avenue, New York, NY 10022.

crease the value of the endowment. The third term represents the effect of inflation. The spending rate represents the rate at which income is drawn from the endowment investments and spent for institutional operating purposes. When we take the rate of return on investments, which is adding to the value of the endowment, add the rate of gift additions, subtract the erosion due to inflation and the spending that is taken out of the endowment, we are left with the last term in the equation: the growth rate of the endowment.

The equation above can serve as a useful basis for putting investment and spending in perspective, and developing an overall policy or strategy for the endowment. It is usually best to think of the rates in the equation in terms of real, or inflation-adjusted rates. For example, if the growth rate of the endowment in real terms is zero, this means that the purchasing power of the endowment will just stay even after the effects of inflation. This is a reasonable objective of a great many institutions. It means that endowment will continue to carry its share of the operations of the institution.

So we might begin by setting the target growth rate at zero. The spending rate needs no adjustment for inflation, since it simply records the current spending divided by the current market value of the endowment. Suppose we begin by assuming that this will be about 5 percent. For most institutions that plan their spending and investment strategy carefully, this rate will be in the 4 percent to 5 percent range.

When we come to the inflation effect, what we are concerned about is not inflation generally, but the extent to which inflation in costs of our institution exceeds inflation in the economy generally. Historically inflation in higher education has run 1 percent to 1 1/2 percent in excess of inflation in the economy generally. This is due to limited opportunities for improving productivity. It may be that we are entering a period when this differential can be reduced. Certainly the last two or three years have seen significant curtailment of expenses in higher education. But much of it has been due to keeping salary increases well below the rate of inflation and whether this can be continued is doubtful. Suppose we use a 1 percent figure for this term.

The expectation with respect to the rate of gift additions will vary a good deal among institutions. Successful institutions with substantial endowments generally find a 2 percent annual rate of gift additions is about all they can hope for. We might aim a little lower and assume a 1 percent rate of additions. At this point, if the equation is indeed to balance, we must be aiming at a rate of return on investments of 5 percent. Now this is a real, or inflation-adjusted, rate of return.

Historically, investments in common stocks over very long periods of time have produced annual average real returns of some 6 percent to 8 percent. Corporate bonds have produced something between 2 percent and 3 percent. U.S. government bonds have produced something less. It is at this point that the advice of a professional manager can be quite helpful. Is it possible to design an investment portfolio that can reasonably be expected to produce a 5 percent real rate of return over future years? If so, what sort of portfolio might this be? One consisting primarily of common stocks or one with a substantial component of bonds? The question is fundamental, because the greater the proportion of common stocks the greater the risk of loss if stocks perform badly. In general, the higher we aim for rate of return the greater the risk we must take.

There are a number of methods for estimating the rate of return on an investment portfolio and at the same time estimating the risk of loss. A good professional manager should be able to present a board of trustees with the set of choices. It may well turn out that there is no portfolio offering an expectation of a 5 percent real rate of return that also offers a satisfactory risk level. If aiming at the 5 percent rate of return involves excessive risk, in the view of the trustees, then we will have to go

back and make some changes in the rates we have estimated for other terms in the equation. Perhaps we can try harder at developing gifts, and raise our estimate of the rate of gift addition. Perhaps we will be forced to cut back on spending from the endowment. Our final objective is a target rate of return on which the trustees can agree that appears to be consistent with a level of risk on which the trustees can also agree.

It is the responsibility of the trustees to communicate to the professional manager their policy with respect to the risk and return trade-off, and it will be best if this policy can be communicated in the form of a judgment as to the appropriate proportions of stocks and bonds in the endowment portfolio.

Measuring investment results

The measurement of investment performance can be a very esoteric subject. But for most purposes, a high degree of sophistication is not necessary. There is a minimum level of trustee responsibility, however, and that is what we shall deal with here.

At many institutions, trustees simply have no idea of the investment performance of their endowment fund. Managers frequently do not report useful performance figures unless they are asked to. Few of us enjoy exposing ourselves to a critical review of our performance, and investment managers are no exception. So long as a board asks no questions, it is not likely to get any answers.

At a minimum, trustees should demand to be told the rate of return, based on market value, for the total endowment fund and for the portion entrusted to each professional manager. Some managers (and this is particularly true of bank trustee departments) will supply a list of all the holdings of a portfolio, together with the market value of each holding, and call this a report of performance.

Some managers do not even go this far, and some will supply a list of holdings at original cost or "book value" which is virtually meaningless. This sort of reporting is unacceptable and any manager not capable of producing an annual rate of return figure, incorporating both income and appreciation, based on market value, is simply incompetent.

Having obtained a measure of investment performance, the board now must decide what to do with it. Professional managers show justifiable anxiety at this stage. The obvious thing to do with the rate of return on a particular endowment portfolio is to compare it with rates of return on other portfolios, mutual funds for example, or the Common Fund stock or bond portfolio, or the performance of stock market or bond market indexes.

Over a short period of time, a year for example, there is a fair amount of random variation in performances of portfolios, variation that is not the result of any inherent quality of management but is simply the result of chance. So a relatively poor performance over a period of a year is not necessarily an indication of low quality management. It is, however, cause for asking questions of the manager. Was the poor performance the result of chance, or did the manager take some unnecessary risks? Was there an unexpected change in strategy? Were there important personnel changes in the management of the endowment?

Over the long term, a consistently poor rate of return, relative to returns on comparable managed portfolios, suggests that a change of management may be appropriate. The difficult question is how long is long term? There is a fairly widespread belief among professional managers and experienced trustees that something like three to five years is necessary before one can use performance figures with confidence in assessing the overall competence of a manager. But over shorter periods of time one can certainly match investment results against the expectations and the behavior of the manager. Risk levels must be taken into account.

As was noted above, the statement of policy furnished to a manager by the

trustees should incorporate both risk and rate of return expectations, and account of this specified allocation. If a manager has been held to a portfolio invested half in common stocks and half in bonds, then that manager should be judged against the performance of other portfolios similarly divided, or against a combination of stock and bond indexes representing the same proportions.

Trustees should be particularly wary of comparisons put before them that do not make this adjustment. Managers seeking to justify their own performance or to win funds from institutions are often guilty of preparing quite inappropriate comparisons. It is not uncommon to discover a comparison being made between a portfolio half invested in bonds and half in stocks and one invested entirely in stocks or entirely in bonds. If the stock and bond markets have performed very differently, then the comparison may be quite deceiving. Confronted with comparative statistics, the trustee should at the very least demand to know the stock/bond ratio for all of the portfolios or indexes included in the comparison.

Dealing with conflicts of interest

Conflicts of interest, or potential conflicts, appear to be disconcertingly widespread in the management of financial assets at colleges and universities. The fact that a great many institutions maintain sizeable non-earning bank balances has been mentioned. Too often an answer may be found in the presence on the board of trustees of the president, or chairman, or prominent director of the institution's commercial bank. Non-interest-bearing checking accounts, at times of high interest rates and shortages of funds like the present, are a very valuable asset to a commercial bank. If an educational institution is willing to make a gift of the use of this asset, the bank is not likely to complain.

Some trustees expect the officers of the institution to protect the institution's assets, and the officers may be well aware of what is going on. But if the bank's representative on the institution's board of trustees is an influential individual, it may be very difficult for an official of the college to interfere. Only trustees can deal with abuses of this sort.

It may even be that the representative of the bank on the board of trustees is unaware of the conflict of interest and has never given any thought to the fact that his or her bank is profiting at the expense of the college or university. There is a natural reluctance on the part of any trustee to point a finger at a fellow trustee. What one generally can do, without touching off a potentially acrimonious discussion, is simply to ask the financial officer of the institution for information on the size of cash balances, the amount kept in non-interest-bearing bank accounts, identification of the banks used, and the amount that is profitably invested. With this information, a trustee can begin to question the handling of short-term funds without necessarily attacking a fellow trustee.

Conflicts connected with the endowment fund are probably less widespread than conflicts connected with investment of short-term funds. The endowment funds of a number of colleges and universities, however, are managed by the trust departments of banks that are in turn represented on the college or university board of trustees. Sometimes the funds are managed by an investment counseling firm that is represented on the board of trustees.

The risk here is not that the use of institutional funds will be given away (although there are circumstances under which that may be a risk) but that poor management may go unquestioned. When the president of a bank of which the trust department manages the institutional endowment reports to his or her fellow trustees that the funds are being well managed, but fails to provide any details, it may take a certain brashness for a trustee to demand something more. The officials of the institution may be well aware of inad-

equate management but f[illegible]el themselves in no position to op[illegible]nly challenge a prominent trustee[illegible] Trustees who accept this sort of repo[illegible]ting from one who has a clear conflict [illegible]f interest simply cannot defend their b[illegible]havior as responsible.

Manager selection and evaluati[illegible]on

The selection, evaluation[illegible] and replacement of investment m[illegible]nagers is at best a difficult task. Institu[illegible]ions with very large endowment funds[illegible] generally spend a substantial amount o[illegible] time and money in their search for i[illegible]vestment managers, and their monitor[illegible]ng of investment results. Even at t[illegible]is level, where the resources are [illegible]available, there is still a large element [illegible]f chance in the selection of good man[illegible]gement. One rule does seem to emer[illegible]e: do not choose a manager on the st[illegible]ength of a recent high level of perfor[illegible]ance, or discharge a manager on the[illegible] strength of a recent low level of perf[illegible]rmance. Indeed, there are those who [illegible]o further and advise hiring managers w[illegible]hose recent performance has been [illegible]poor on the grounds that the behavi[illegible]r of the stock market suggests a very [illegible]poor performance is likely to be follo[illegible]wed by a very good performance. W[illegible]ether or not one wishes to take this [illegible]ather extreme position, history at lea[illegible] teaches us that discharging managers [illegible]immediately after poor performance [illegible] or hiring managers immediately af[illegible]er good performances, is a very [illegible]xpensive process with frequently disas[illegible]rous results.

Relatively few institutions [illegible]ave endowment funds large enough [illegible]o justify hiring a separate manager. It [illegible]s probably not economical, from the [illegible] manager's point of view, to provid[illegible] careful and constant management of [illegible] portfolio under $1 million. The fees [illegible]that can be earned simply will not sup[illegible]ort consistent and careful managem[illegible]ent. For funds under $1 million then, [illegible]articipation in some sort of investm[illegible]nt pool is the answer. Dividing the [illegible] money among mutual funds or inves[illegible]ing it in bank-managed pooled funds [illegible]may be wise. The Common Fund was [illegible]ounded largely to offer the benefits of pooling to institutions with small portfolios.

For funds larger than $1 million there are still significant advantages in the pooled fund approach. An endowment needs to be very large before it can expect the same quality of management, at a reasonable fee, that will be enjoyed by large pooled funds.

Summary and conclusions

Endowments are not simply a luxury possessed by the 200 or so well-endowed institutions. Some 1,700 colleges and universities have endowments of some sort. For institutions facing serious financial difficulties and willing to make the effort, endowment may be the key to survival. Even larger than the number of institutions with some endowment to manage is the number of institutions with cash balances, a valuable income-producing resource. The potential for improving the productivity of these cash balances is substantial, and trustees should be asking questions and insisting on adequate management.

Setting investment objectives for endowment funds is a basic responsibility of college and university trustees, one that cannot be passed to professional managers. It is possible to put together a consistent set of objectives including growth of the endowment to maintain purchasing power, spending for current use in the institution, and an investment strategy to aim at the required investment return.

It is important that trustees be aware of the performance record of their endowment funds, that they compare this record with the performance of the funds and of market indexes, and that they do not allow themselves to be misled by deceptive comparisons.

Conflicts of interest are uncomfortably common in the management of financial assets at colleges and universities. Individual trustees must take the responsibility for identifying conflicts and potential abuses, and for eliminating them. It is not satisfactory to depend upon officials of the institution who lack the independence and free-

dom of action of trustees.

The selection and evaluation of professional managers for endowment funds is a difficult task. For institutions that do not have the resources to conduct exhaustive reviews of candidates, and do not have large enough endowments to demand separate management, the use of pooled funds is an obvious and attractive alternative. Selection of appropriate pooled funds still remains a trustee obligaion. Use of the Common Fund can simplify even this task.

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